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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, PAINEWEBBER INCORPORATED, AND DEAN WITTER REYNOLDS INC.,

Petitioners,

v.

JEFFREY PHILLIP KRAVITZ, GLORIA BINDER, and BRUCE ZAKHEIM IRA FBO BRUCE ZAKHEIM,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF THE BOND MARKET ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF THE PETITIONER

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Questions Presented*

Petitioners are registered broker-dealers that make markets in over-the-counter securities, trading for their own accounts with their customers. During the class period alleged in this case, the staff of the Securities and Exchange Commission, petitioners' primary regulator, stated that a broker-dealer's "duty of best execution" of customer market orders is satisfied by "executions * * * based on the NASDAQ national best bid or offer [the 'NBBO'] * * * absent customer instructions to the contrary." Execution of small retail orders at the NBBO was also virtually universal industry practice. Nevertheless, the en banc Third Circuit ruled in this case that a broker-dealer's duty of best execution requires it "to maximize the economic benefit to [its customer]" and that a broker-dealer that routinely executes small customer orders at the NBBO may have violated SEC Rule 10b-5 unless it has affirmatively disclosed to its customer that it will not seek better prices. The questions presented by this ruling are:

1. Whether a broker-dealer that makes no false statement, obeys all customer instructions, and routinely executes small retail orders at the NBBO in accordance with SEC guidance and virtually universal industry practice can be found to have acted with "scienter" as defined in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), because it did not seek better prices for the customer.

2. Whether, if a broker-dealer has a fiduciary duty to customers to seek out better-than-NBBO prices, its failure to seek out such prices can be bootstrapped from a breach of fiduciary duty into fraud, notwithstanding *Santa Fe Industries v. Green*, 430 U.S. 462 (1977), simply by alleging that the firm

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* These questions are set out as stated in the petition.

failed to disclose that it would not seek out such prices.

3. Whether, under the "shingle theory," a market maker has an obligation, in determining prices, "to maximize the economic benefit to the [customer]" rather than merely comply with all laws, all SEC regulatory requirements and guidance, and general industry practice.

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Interest of the *Amicus Curiae*

The Bond Market Association submits this brief as *amicus curiae* with the consent of the parties as specified in this Court's Rule 37.2(a).[1] The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt

[1] Copies of the letters of consent have been filed with the Clerk of the Court. This brief was not authored in whole or in part by counsel for a party, and no person or entity, other than the *amicus curiae*, its members, and their counsel made a monetary contribution to the preparation and submission of this brief.

securities in the United States and international markets. The Association's members deal in a wide variety of public and private debt securities. The Association's member firms account for in excess of 95% of all primary issuance and secondary trading activity in the domestic debt capital markets.

Since its inception in 1976,[2] the Association has addressed significant issues that confront the securities industry, fostered sound credit, business and trading practices for participants in the bond markets, and undertaken initiatives to improve market efficiency. The Association has been particularly active in addressing issues relating to the regulation of the industry by providing its views on securities legislation and regulation and participating in the development of trading practice standards.

The Bond Market Association has an interest in the outcome of this case. The debt markets, like the over-the-counter equity markets traded through the facilities of NASDAQ, are heavily regulated by the Securities and Exchange Commission ("SEC") and self-regulatory organizations ("SROs") such as the New York Stock Exchange and the National Association of Securities Dealers ("NASD"). In addition to issuing the rules and regulations that govern industry practice, the SEC and the SROs, in their role as market regulators, frequently offer guidance to bond market participants in the form of rule proposals, releases and studies of industry practice. The Association's members, as major dealers in this country's bond market, rely on this guidance in establishing trading practices and making business decisions.

The en banc Third Circuit's decision directly calls into question the extent to which broker-dealers and bond market

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[2] The Bond Market Association was previously named the Public Securities Association.

participants may continue to adhere to SEC and SRO guidance and wide-spread industry practice in establishing trading practices without being retrospectively exposed to liability for fraud for having done so. The decision held that a broker-dealer could be found liable for fraud — a manipulative or deceptive act — for engaging in a trading practice that was consistent with SEC and SRO guidance and was virtually universally adopted in the industry. This decision, if allowed to stand, would have industry-wide impact, as it would leave broker-dealers without an important guidepost by which to develop business and trading practices. Much of the litigation regarding the conduct of participants in the debt markets, like in the over-the-counter equity markets, is brought under Section 10(b) and Rule 10b-5. The Association has a vital interest in ensuring that the securities laws are interpreted reasonably and consistently, so as to allow its members to act in an environment of legal certainty that will provide stability in the marketplace. Thus, *amicus* submits this brief to assist this Court in its evaluation of the petition for certiorari.

Introduction and Summary of Argument

This Court has held that a cause of action under Section 10(b) and Rule 10b-5 will lie only in cases of actual fraud, in which the defendant possesses the intent to deceive, manipulate or defraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The decision of the en banc Court of Appeals marks a significant departure from this standard.

This case deals with the trading practices of three broker-dealers participating in the NASD Automated Quotation ("NASDAQ") over-the-counter securities market. During the time period at issue in the case, the three broker-dealers executed small customer market orders based on a pricing system called the NASDAQ national bid and best offer

("NBBO"). The respondents, individual investors who placed trade orders with the broker-dealers, alleged that the practice of executing at the NBBO did not achieve the best price possible for certain trades, and thus, the broker-dealers, by always executing at the NBBO price, intentionally defrauded the investors. (Pet. 8).

The en banc Court of Appeals held that the broker-dealers have a "duty of best execution" which requires them to maximize the economic interests of their clients. (Pet. App. 7a). The court found that a reasonable jury could find not only that the broker-dealers breached their duty of best execution, but that the broker-dealer's conduct could be found "at least reckless, if not intentional," and thus a fraud in violation of Section 10(b) and Rule 10b-5. (Pet. App. 13a).

This decision was reached in apparent disregard of the fact that both the SEC and the NASD had issued statements prior to or during the class period taking the position that in the context of small orders in the NASDAQ market, a broker-dealer's duty of best execution is satisfied by executing a trade at the NBBO. In addition, although the panel acknowledged that "execution of customer orders at the NBBO was a practice 'widely if not almost universally followed' in the securities industry during the class period," the panel failed to elucidate any rationale supporting liability consistent with the requirement of an actual intent to deceive, manipulate or defraud. (Pet. App. 15a).

The regulatory context, together with the open and near universal nature of the market practices in this case, effectively eliminate the "scienter" requirement established in *Hochfelder*. In a highly regulated industry like the over-the-counter debt markets, a broker-dealer, following a well-accepted industry practice that is consistent with regulatory guidance, cannot as a matter of law act with the fraudulent intent required by

Hochfelder. Broker-dealers must be able to gauge their practices by using the pronouncement of regulators and industry practices as guideposts.

ARGUMENT

I. The Court of Appeals Erred in Determining That Broker-Dealers Acting Within the Bounds of Regulatory Guidance and Established Industry Practice Possessed the Scienter to Defraud Their Customers

This Court has historically limited Rule 10b-5 actions to "intentional or willful conduct designed to deceive or defraud investors . . . ." *Hochfelder*, 425 U.S. at 199. This Court has held that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud." *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980). The en banc Court of Appeals, however, found a cause of action to lie where the conduct of the broker-dealers fell far short of deceit or fraud. The trading practice at issue in this case was consistent with regulatory guidance and was designed in accordance with industry practice. Thus, the open practice of these broker-dealers could not also have also been "designed to deceive and defraud investors." Conformity to regulatory guidance and industry practice shows, particularly in a heavily regulated industry like the securities markets, the antithesis of the intent required by *Hochfelder*.

At the center of this case is what has been termed the "duty of best execution." The decision below turned on whether the petitioner broker-dealers' practice of trading small orders at the NBBO was a breach of that duty. The duty of best execution has eluded clear interpretation. According to the SEC, the duty is derived from concepts of common law agency and from the "shingle theory," which holds that "a broker-dealer impliedly

represents at the outset of a securities transaction that it will deal with its customers fairly and in accordance with the standards of the industry." *Market 2000: An Examination of Current Equity Market Developments, Study V, Best Execution*, 1994 SEC LEXIS 136, *2-3 & n.7 (Jan. 1994). The duty of best execution is an extension of the shingle theory and, in general terms, according to the SEC, requires "that [a] broker endeavor, using due diligence, to obtain the best execution possible given all of the facts and circumstances." *Id.* at *7-8. However, as the en banc Court of Appeals recognized, the SEC's view of the precise contours of the duty of best execution is constantly evolving. *Id.*

The SEC and the NASD have both made clear pronouncements that the execution of small over-the-counter stock trades at the NBBO satisfies the duty of best execution. In July of 1991, more than a year before the beginning of the class period, a special committee appointed by the NASD Board of Governors and headed by former SEC Chairman, David S. Ruder, issued a report which stated in relevant part:

> [The committee] believes that when orders are executed at the best current displayed bid or offer that investors receive best execution of their small-sized orders . . .

Inducements for Order Flow, A Report to the Board of Governors, National Association of Securities Dealers, at 28 (July 1991). In addition, in January of 1994, midway through the class period, the SEC issued an in-depth examination of the duty of best execution which expressly addressed the best execution obligations of broker-dealers trading in the NASDAQ market. *Market 2000*, 1994 SEC LEXIS 136, at *15. The report distinguished the over-the-counter NASDAQ market, which relies on geographically dispersed dealers, from an

exchange market based on order interaction on a trading floor, and found that in the NASDAQ market:

> it is reasonable to accept quote-based executions of market orders based on the NASDAQ best bid or offer as consistent with best execution, absent customer instructions to the contrary.

Id. These unequivocal statements of policy supported a widely followed industry practice and provided the broker-dealers in this case a reasonable basis to believe that trading at the NBBO satisfied the duty of best execution.

In addition, in 1984, the SEC and NASD created an automated system for executing small trades of over-the-counter stock called the Small Order Execution System ("SOES"). (Pet. App. 45a). During the class period, the SOES system automatically directed orders to the market maker displaying the best bid or offer (NBBO) price at the time of the trade. *Id.* The SOES system was specifically designed to provide the industry with "an enhanced mechanism for the efficient and economic execution and clearance of transactions in over-the-counter securities." *Notice of Proposed Rule Change*, Exchange Act Release No. 34-21433, 49 Fed. Reg. 44,042, 44,044 (Nov. 1, 1984).

After the class period, the SEC reaffirmed that execution at the NBBO has long been viewed as satisfying best execution obligations. *Order Execution Obligations*, Exchange Act Release No. 34-36310, 60 S.E.C. Docket 919 (Sept. 29, 1995). In addition, the NASD's General Counsel provided an affidavit in this case stating that, "[t]he NASD has viewed [execution at the NBBO] as consistent with the duty of 'best execution' that broker-dealers assume when they accept customer orders." Pet. App. 50a (bracketed material supplied by the district court).

In determining that the broker-dealers in this case could be found to have acted with intent to defraud their customers, the en banc court did not even consider this clear SEC and NASD guidance regarding execution at the NBBO. The court instead referred to other statements in the SEC's *Market 2000* report regarding the duty of best execution that are more general in nature. The opinion asserts that :

> the SEC has consistently taken the position that the evolving nature of the markets requires a broker-dealer to 'periodically assess the quality of competing markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer's order.'

(Pet. App. 9a) (quoting *Market 2000 Report*, 1994 SEC LEXIS 136, at *11-12). The district court also noted other SEC and NASD statements made during the class period that were more equivocal as to whether execution at the NBBO in all circumstances and for all times always satisfied the duty of best execution. (Pet. App. 51a).

The broker-dealers' practice was consistent with the only clear statements regarding best execution issued by the SEC and the NASD during the class period. The fact that other, more general statements regarding the duty of best execution were also made by the regulators during the same time period cannot make reliance on the unequivocal pronouncements bad faith or deceit. If in fact the regulators believed executing small orders at NBBO was fraudulent, the industry had every reason to believe they would have said so — and not indicated to the contrary. Given these facts and the record here, the broker-dealers cannot be found to have been acting with the intent to defraud.

The en banc Third Circuit opinion to the contrary is in conflict with the decisions of other circuits. In *Banca Cremi, S.A. v. Alex. Brown & Sons*, 132 F.3d 1017 (4th Cir. 1997), the case turned on whether the defendant had the duty to disclose mark-ups that the plaintiff claimed were fraudulent. *Id.* General guidance was available from case law to the effect that "[a] mark-up is excessive when it bears no reasonable relation to the prevailing market price." *Id.* at 1033 (citation omitted). The Board of Governors of the NASD had determined that "[a]lthough each case requires an independent analysis . . . as a general guideline, a five percent mark-up is reasonable." *Id.* The Fourth Circuit found that "the alleged presumption of scienter in the instant case is rather difficult to square with the uncontested fact that Epley and Alex. Brown stayed within the NASD five percent guideline on all of the markups with two exceptions." *Id.* at 1037 n.26. The court further found that "[i]n light of the defendants' adherence to an industry-wide guideline, the plaintiff has rather a heavy burden to persuade that the defendants nevertheless knew that their [conduct was fraudulent.]" *Id.*

Similarly, in *Platsis v. E.F. Hutton & Co.*, 946 F.2d 38 (6th Cir. 1991), the Sixth Circuit found that adherence to industry practice precludes a finding of intent to defraud. The trial court had held that the defendant's failure to disclose the amount of production credits and mark-ups was a "deliberate" and "material" omission giving rise to an action under Rule 10b-5. The appellate court reversed, holding that:

> Since very few brokers disclosed these credits at the time these events took place and there was no established regulatory duty to disclose these items, an intent to deceive or an 'extreme departure from the standards of ordinary care' could not be established

> merely by the omission of this information in the absence of special circumstances.

Id. at 41. *See also Messer v. E.F. Hutton & Co.*, 847 F.2d 673, 679 (11th Cir. 1988) (no scienter where broker "made a reasonable decision well within the bounds of accepted industry practice").

As these opinions demonstrate, this Court should grant certiorari to review the Third Circuit en banc decision which finds intent to defraud based on conduct that can only be interpreted as good faith, and thus effectively eliminates the scienter requirement established by this Court in *Hochfelder*.

II. The Court of Appeals' Erosion of the Scienter Requirement Will Create Uncertainty in the National Securities Markets

One of this Court's express goals in establishing limits for the Rule 10b-5 action has been "to promote clarity, consistency, and coherence for those who rely upon, or are subject to, 10b-5 liability." *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 295 (1993) (citations omitted). The *Hochfelder* formulation, limiting 10b-5 actions to cases of actual fraud, has provided the industry with clear guidance. The industry is on notice that fraudulent acts can give rise to liability, and the industry participants conduct their business accordingly. The en banc Court of Appeals decision, on the other hand, will result only in confusion. If broker-dealers may no longer rely on regulatory guidance and industry practice, they will have lost two of the important touchstones by which they have, in the past, evaluated the propriety of their business practices. The clarity of the legal and regulatory scheme that governs the securities industry will be seriously compromised, leading to confusion and market inefficiencies.

The Third Circuit decision will have an impact on securities markets nationwide. As a result of the electronic links between broker-dealers all over the country, the securities markets are national, not regional. And, because of the broad venue provisions in the securities laws, broker-dealers around the country are potentially within the reach of Third Circuit law. *See* 15 U.S.C. § 78aa (1997). This Court should grant certiorari to restore clarity to Section 10(b) and Rule 10b-5.

CONCLUSION

The petition for a writ of certiorari should be granted.

Dated: New York, New York
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